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ATTORNEYS BEWARE: INCREASED LIABILITY FOR PROVIDING ADVICE TO CORPORATE CLIENTS ISSUING SECURITIES

INTRODUCTION

At a time in the not too distant past, attorneys could reasonably expect to remain on the sidelines of any litigation arising from their participation in the issuance of securities. Although banks,¹ accountants,² investment bankers,³ employees of corporations issuing securities,⁴ stock brokers,⁵ and even stock exchanges⁶ have been held liable for securities law violations as a result of their participation in or connection with a defendant who has violated a securities law, attorneys were previously insulated from such litigation. However, this was apparently forgotten in 1968 when the Southern District of New York held that two attorneys who had participated in the preparation of a prospectus used by a corporate issuer of securities were among a group of defendants liable to purchasers of the securities for the losses due to a decline in the value of the stock that they had purchased.⁷ Although this holding did not open the floodgates of litigation involving attorneys as defendants for securities laws violations, it may have been indicative of things to come.

Recent headlines have informed us that attorneys can and will be held liable for securities law violations. It is important to remember that the threat of litigation can be just as costly as an actual negative verdict in a trial. This potential liability for attorneys can be clearly seen in the recent cash settlement of \$40 million entered into by the New York law firm of Rogers & Wells because of their representation of a California investment firm.⁸ Another example is the recent suit brought by First Bank Minneapolis against their own

¹See, e.g., *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir. 1978), *cert. denied*, 439 U.S. 930 (1978); *Rosen v. Dick*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786 (S.D.N.Y. Sept. 3, 1974).

²See, e.g., *Kestenbaum v. Emerson*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,330 (S.D.N.Y. March 19, 1980); *H.L. Green Co. v. Childree*, 185 F.Supp. 95 (S.D.N.Y. 1960).

³See, e.g., *IIT v. Cornfield*, 619 F.2d 909 (2d Cir. 1980).

⁴See, e.g., *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980), *cert. denied*, 449 U.S. 1011 (1980); *Holloway v. Howerdd*, 536 F.2d 690 (6th Cir. 1976).

⁵See, e.g., *Schillner v. H. Vaughn Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943); *Cady v. Murphy*, 113 F.2d 988 (1st Cir. 1940), *cert. denied*, 311 U.S. 705 (1940).

⁶See, e.g., *Pettit v. American Stock Exch.*, 217 F.Supp. 21 (S.D.N.Y. 1963).

⁷*Escott v. Barchris Constr. Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968).

⁸The *National Law Journal*, April 14, 1986, at 1, col. 1. Rogers & Wells were named as defendants due to their representation of a California investment firm known as J. David & Co. The principal thrust behind plaintiff's claim is that Rogers & Wells became aware or should have known of the fraud being perpetrated by J. David Co. Although Rogers & Wells apparently avoided litigation, they were subsequently named as a defendant in another suit. At the present time, there has not been a settlement or trial on the merits so the issue of Rogers & Wells ultimate liability is still unclear. For further discussion see The *National Law Journal*, May 5, 1986, at 3, col. 1.

outside counsel, Dorsey & Whitney.⁹ Although the case was settled on the eve of the trial, it provides an indication that attorneys are no longer insulated from the threat of litigation for alleged securities law violations.

Although the law in this area is rapidly evolving, a general overview of recent case law seems to indicate that attorneys may be liable even though their participation in the issuance of securities only involved rendering routine services to a corporate client. If an attorney were to have an active part in activities such as business planning or the promotion of securities, their exposure to potential liability would increase dramatically. As a result of this rapid change in the law, there is a degree of uncertainty concerning the potential liabilities attorneys may face when assisting their corporate clients in issuing securities. In an attempt to address some of this uncertainty, this article will analyze the potential liability for attorneys under three provisions of the federal securities laws. Although there are other sections of the 1933 and 1934 Acts under which an attorney may be subjected to liability, because the bulk of the litigation involving the issuance of securities has been brought primarily under three sections, those sections will be the primary focus of this article. These provisions are Sections 11 and 12 of the Securities Act of 1933, and Section 10(b) of the Securities and Exchange Act of 1934.

POTENTIAL CLAIMS UNDER THE SECURITIES ACT OF 1933

Section 11 Claims

This Section of the 1933 Act imposes civil liability on five types of individuals for misrepresentations or omissions in registration statements that must be filed with the Securities and Exchange Commission in order to sell securities. Although Section 11 provisions for liability are extensive, the statute explicitly delineates the types of individuals upon whom liability may be imposed. Individuals subject to liability under Section 11 include: everyone who signs a registration statement; all directors or partners of the issuing company; all persons, who consent, who are about to become a director or partner; any expert who assists in the preparation or certification of the registration statement; and, the underwriters of any security.¹⁰

Although the individuals potentially liable under Section 11 are numerous, all those potentially liable, with the exception of the issuer, are afforded the opportunity of asserting a defense of due care. The extent of liability and the type of due care defense available to defendants under Section 11 will

⁹The National Law Journal, August 11, 1986, at 3, col. 1. First Bank brought a suit against Dorsey & Whitney for the firms involvement of the public offering of securities giving an interest in the monorail at the Minnesota Zoological Gardens. First Bank claimed that Dorsey & Whitney represented all parties involved in the offering and that they also were aware of the misrepresentations made by the investment banking firm of Smith Barney. Although Dorsey & Whitney ultimately settled on the eve of trial, the suit exhibits the expanding potential for the threat of liability to be used as a tool by plaintiffs against defendant-attorneys in securities litigation.

vary depending on whether or not a defendant is an expert, or if the false statement was made under the authority of an expert who gave their consent to be named as an expert in a registration statement.

In the case of an expert, the expert can only be held liable for statements which he rendered as a professional opinion.¹¹ However, this is not absolute liability and in the event that an expert's statements are proven inaccurate, the expert may assert that he had conducted an investigation and reasonably believed the statements he made were correct.¹² On the other hand, there is the liability faced by a lay defendant. Excluding that portion of the registration statement prepared by experts, other potential defendants are liable for the truth and completeness of the entire registration statement. However, these potential defendants are also given the opportunity to assert an affirmative defense of reasonable investigation and a belief in the accuracy of the data contained in the registration statement.¹³ The statute goes further to inform us that the standard of reasonableness required to assert such a defense is that reasonableness which would be "required of a prudent man in the management of his own property."¹⁴ However, any portion of the registration statement prepared by experts permits the lay defendant's duty of care to be much lower. The portion of the registration statement prepared by experts requires no investigation by the nonexpert defendants and the nonexpert defendants only need to show that there was no reasonable grounds available to indicate that the expert's statements were false or misleading.¹⁵

If an individual defendant is unlucky enough to be classified as an appropriate defendant as delineated in Section 11(a)(1)-(5), and they cannot effectively assert a defense of due care, the probability of avoiding liability becomes

¹¹15 U.S.C. § 77(k)(a)(4) (1975).

¹²*Id.* at § 77(k)(b)(3)(B)(i) (1975). A review of the exact statutory language may be helpful. The statute states that an expert may assert a due diligence defense after "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ."

¹³*Id.* at § 77(k)(b)(3)(A) (1975). The exact language in the statute which allows this defense is "as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ."

¹⁴*Id.* at § 77(k)(c) (1975).

¹⁵*Id.* at § 77(k)(b)(3)(c) (1975). The language excusing a defendant from reviewing an experts portion of the registration statements states that "as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert) other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert . . ."

very slim. Due to the express liability provisions which are subject to certain enumerated defenses, plaintiffs are not required to show reliance on the false or misleading statements, or causation of damages to establish a cause of action under Section 11.¹⁶ The only hope a defendant has of escaping liability is if he can support the highly unlikely contention that the decline in the value of plaintiff's holdings was unrelated to the material misrepresentations or omissions.¹⁷

For liability to be imposed upon an attorney, he must fall into one of the five previously noted categories. If an attorney were a member of an issuing corporations board, it is quite obvious that he could be subjected to liability. However, if an attorney does not fall into one of the five classes, he probably will not be subject to liability under Section 11. Nevertheless, it has frequently been asserted that an attorney who prepares a registration statement should be found to be an "expert" under Section 11, and therefore be subjected to liability.¹⁸

The first case to squarely address the issue of an attorney as an expert and the subsequent liability under Section 11 was *Escott v. Barchris Construction Corporation*.¹⁹ The claim plaintiffs asserted in *Barchris* was brought under Section 11 of the Securities Act of 1933.²⁰ The instrument alleged to have contained false information and material omissions was the registration statement for 5.5 per cent convertible subordinated fifteen year debentures that were issued by Barchris Construction Corp.²¹

Although two of the attorneys involved in *Barchris* were ultimately found liable for violations of Section 11, several interesting facts should be highlighted before jumping to any conclusions about the liability of attorneys under Section 11. First, it should be recognized that both of the attorneys who were defendants in *Barchris* were on the board of directors of Barchris Construction Corp.²² It seems apparent that the defendants in this instance were corporate directors first and attorneys second. However, several of the attorneys' co-defendants in *Barchris* attempted to assert that because the registration statement was prepared by one of the corporate director's (defendant-attorneys) law firms, that the entire statement was prepared by an expert and therefore the nonexpert defendants should be excused from liability.

¹⁶*Emmi v. First Manufacturers Nat'l Bank*, 336 F.Supp. 629 (D.C. Me. 1971).

¹⁷*Greenapple v. Detroit Edison Co.*, 618 F.2d 198 (2d Cir. 1980).

¹⁸See *Escott*, 283 F. Supp. 643; *In re Flight Transp. Corp. Sec. Litig.*, 593 F. Supp. 612 (D. Minn. 1984).

¹⁹283 F. Supp. 643 (S.D.N.Y. 1968).

²⁰15 U.S.C. § 77(k) (1975). Plaintiffs challenged the accuracy of several figures that were contained in the prospectus and the registration statement. Plaintiffs also alleged that the text of the prospectus lacked material information and contained false information in numerous instances. *Escott*, 283 F. Supp. at 655.

²¹*Escott*, 283 F. Supp. at 652.

²²*Id.* at 686-89. Even assuming that defendant-attorneys were not experts, they still would have faced liability as a corporate director under § 77(k)(a)(2).

ty.²³ In rejecting this assertion the court stated that to say that the entire registration statement was prepared by an expert simply because it was prepared by a lawyer would be an unreasonable construction of the statute.²⁴ Therefore, it appears as if the only area where an attorney should be subjected to expert status is where an attorney would render opinions on such matters such as the status of pending litigation or the worthiness of title to real property. To find that an attorney, acting as a mere scrivener, should be subjected to liability for the entire registration document, does not meet the requirements of an expert under Section 11.²⁵ Additionally, by a simple preparation of a registration statement, one could argue that an attorney does not consent to the use of his name as an expert as to every statement made in the registration statement. Therefore, an attorney acting as a draftsman for a registration statement falls comfortably short of being lofted to the unenviable status and liabilities of an expert. To assume otherwise would mean that all non-attorney, non-expert defendants under Section 11 claims could escape liability simply by claiming a Section 11(b)(3)(c) defense.²⁶ This would hardly seem to be in focus with the remedial nature of the statute.

In a recent case, a plaintiff attempted to rely on *Barchris* and impose liability on attorneys who had drafted the registration statements for a corporation issuing 30 day variable rate demand notes, and who indicated that they had "passed upon all legal matters" in connection with the registration statement.²⁷ In *Ahern v. Gaussoin*, the plaintiffs asserted that because defendant attorneys had extensive knowledge of issuer's business affairs and were involved a great deal in the offering of the notes, that the attorneys should be liable as experts under Section 11(a)(4) of the 1933 Act.²⁸ Defendant-attorneys argued that for an attorney to be liable under Section 11, such liability would only arise if they render their opinion as an expert on a particular matter.²⁹

In rejecting plaintiff's claims attempting to hold attorney-drafters liable under Section 11, the court stated that there are certain individuals who should not be subjected to liability because they participated in the preparation of a registration statement.³⁰ These excluded individuals should include attorneys

²³*Id.* at 683.

²⁴*Id.* at 683. The court explicitly rejected this assertion and stated: "Neither the lawyer for the company nor the lawyer for the underwriters is an expert within the meaning of Section 11. The only expert, in the statutory sense," were the auditors, "and the only parts of the registration statement which purported to be made upon the authority of an expert were the portions which purported to be made on" the auditor's authority.

²⁵*Id.*

²⁶15 U.S.C. § 77(k)(b)(3) (1975). This defense allows non-expert defendants to avoid liability if a portion of the statement was prepared by an expert. However, liability may only be avoided for the portion of the registration that has been prepared by an expert.

²⁷*Ahern v. Gaussoin*, 611 F.Supp. 1465 (D.C. Or. 1985).

²⁸*Id.* at 1482.

²⁹*Id.*

³⁰*Id.*

not acting as experts.³¹

The argument that attorneys who prepare registration statements are not experts under Section 11(4) can be strengthened by reliance on another recent United States District Court decision.³² In *In Re Flight Transportation Corporation Securities Litigation*, plaintiffs attempted to assert that defendant-attorneys³³ were experts because they were named in the prospectus as having drafted the instrument.³⁴ In rejecting this argument, the court relied on *Barchris* and reiterated the holding that:

to state that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute.³⁵

However, while it appears *Barchris* is granting attorney-directors the luxury of a defense with a standard similar to that of a lay director, the court in another portion of its discussion gave an indication that attorney-directors such as those in *Barchris* may be held to a higher standard by stating:

as the director most directly concerned with writing the registration statement and assuring its accuracy, more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work.³⁶

Although this language appears to create a higher standard of care for attorney-directors, it is apparent from a review of other case law that attorneys who are not directors and act only as scrivenors may not be held liable as experts under Section 11 of the 1933 Act. It would appear that if an attorney were to fall into one of the other categories of individuals liable under Section 11, they would be held to a higher standard of liability in reviewing the registration statement. The reason for this higher standard of accountability is the presumption that attorneys are more familiar with the securities laws and because they actually were involved with the preparation of the registration statements.³⁷

³¹*Id.* The court relied upon the United States Supreme Court case of *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 (1983). In rejecting plaintiffs argument based on the *Barchris* decision, the *Ahern* court stated that *Barchris* was clearly distinguishable because the attorney-defendants in that case were also directors and were therefore subject to liability under § 11(a)(2) because of their capacity as a director.

³²*In re Flight Transp. Corp. Sec. Litig.*, 593 F. Supp. 612 (D. Minn. 1984).

³³*Id.* at 616. Defendants served as counsel to the underwriting firm who originally sold securities and assisted Flight Transportation Corporation in the preparation of required registration statements.

³⁴*Id.*

³⁵*Id.* at 616 citing *Escott*, 283 F. Supp. at 683.

³⁶*Escott*, 283 F. Supp. at 690. As a defense the attorney-director asserted that for such a standard to be applied to him, this would be analogous to requiring an issuing company's attorney make an independent audit of the figures supplied to him by the issuing company. In rejecting this argument the court indicated that the question was did the attorney-director make a reasonable effort to detect errors and omissions which could have been discovered without an audit.

³⁷*Id.*
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Another potential area of liability for attorneys under Section 11 of the 1933 Act, may be a claim that an attorney aided and abetted an individual who violated federal securities laws. However, as the *Flight Transportation* court pointed out, because the statute specifically delineates who may be held liable for violations of Section 11, the courts should not extend liability through a theory of aiding and abetting to other persons who are not included in the categories of potential defendants.³⁸

Section 12 Claims

Another area of potential liability for attorneys assisting in the issuance of securities is Section 12 of the 1933 Act. This Section provides for civil liabilities and a remedy for purchasers of securities when the offer or sale was made with false or misleading statements or material omissions in an oral statement or prospectus.³⁹ The major difference between Sections 11 and 12 is that Section 12 does not specifically delineate appropriate categories of defendants. Instead, Section 12 provides for the imposition of liability upon any "seller" of a security.⁴⁰ Like Section 11, under Section 12 it is possible to impose liability for mere negligence. Additionally, although the plaintiff must prove that he had no knowledge of the untruth or omission, if a defendant attempts to rely on an affirmative defense of due care or due diligence, the burden of proof is then on the defendant.⁴¹

Although there are other federal securities law provisions that expressly

³⁸*Flight Transportation*, 593 F. Supp. at 616, citing *In re Equity Funding Corp. of America Sec. Litig.*, 416 F. Supp. 161, 181 (C.D. Cal. 1976). Other cases holding that an attorney cannot be found liable under § 11 of the 1933 Act through a theory of aiding and abetting include *Ahern*, 611 F. Supp. at 1465; *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028, 1034 (D. Minn. 1981); *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 642 (N.D. Cal. 1980). The most notable exception to this proposition is *In re Caesar's Palace Sec. Litig.*, 360 F. Supp. 366, 378-84 (S.D.N.Y. 1973). However the *Flight Transportation* court specifically rejected the *Ceasar's Palace* decision and relied upon the *Herman & MacLean v. Huddleston* decision rendered by the Supreme Court.

³⁹15 U.S.C. § 77(1) (1975). This section provides for civil liabilities for: "[A]ny person who —

- (1) offers or sells a security in violation of section 77(e) of this title, or
- (2) offers or sells a security (whether or not exempted by the provisions of section 77(c) of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

⁴⁰15 U.S.C. § 77(b)(3) (1975) defines the terms "sell" and "offer to sell." Additional help in defining these terms can be found in Rules 138 and 139 that accompany the Securities Act of 1933, see 17 C.F.R. §§ 230.138 and 230.139 (1986).

⁴¹For a better discussion of the elements of and who has the burden of proof in a § 12 claim, see *The John Hopkins Univ. v. Hutton*, [1968 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,268 (D. Md. 1968).

make securities fraud illegal,⁴² Section 12(2) explicitly permits a plaintiff to bring a civil action against a seller,⁴³ and seek to recover damages or a rescission of the purchase.⁴⁴ However, a potential obstacle for individuals attempting to assert a Section 12 claim is that the buyer's remedy is limited to the immediate seller.⁴⁵ This requirement of privity would seemingly insulate a remote seller or his associate from liability for fraud.⁴⁶ However, courts have had little difficulty in placing liability upon agents or brokers who represent the seller.⁴⁷ In fact, there have been occasions where a court has completely relaxed the privity requirement and used language such as "participants in a sale" interchangeably with the word "seller."⁴⁸ Fortunately for attorneys, persons held liable as participants have generally been individuals who had active roles in the solicitation of purchasers or consummation of the transaction, and who were aware of the fraud that was being perpetrated.⁴⁹

Therefore, it appears that an attorney who has done nothing more than provide routine service and advice to a client without having direct investor contact would be fairly insulated from Section 12 liability. One noted authority has even gone so far as to assert that absent knowing participation in the propagation of the misleading material, liability should not be extended to an attorney unless the attorney was aware of the possibility of fraud.⁵⁰ This conclusion that Section 12 liability only extends to "sellers" of a security places great

⁴² § 17(a) of the 1933 Act and § 10(b) of the Securities Exchange Act of 1934 contain anti-fraud provisions that make it unlawful to use any manipulative or deceptive devices in connection with the sale of a security. 15 U.S.C. § 77(q) (1975) and 15 U.S.C. § 78(j) (1983).

⁴³ See *Collins v. Signetics Corp.*, 605 F.2d 110, 113 (3d Cir. 1979). This court held that § 12(2) allowed the purchaser to bring a claim against the immediate seller.

⁴⁴ For a good discussion of the remedies generally available under § 12(2) see Peterson, *Recent Developments in Civil Liability Under Section 12(2) of the Securities Act of 1933*, 5 HOUS. L. REV. 274 (1967). Although this article is 20 years old, it provides an excellent overview of remedies available to buyers and defenses available to sellers.

⁴⁵ The relevant part of the statute that indicates this requirement of privity is as follows: "Any person who offers or sells a security . . . shall be liable to the person purchasing such security from him . . ." 15 U.S.C. § 77(1)(2) (1975). For the full text of this statute, see note 39 *supra*.

⁴⁶ A good example of such a situation would be where the person or entity passing title to the security is not responsible for the omission or misrepresentation, rather his agent is the true violator of § 12. For example, a stockbroker who fraudulently arranged a sale, may avoid liability because the immediate seller is the client. See W. CARY & M. EISENBERG, *CASES & MATERIALS ON CORPORATIONS* 1194 (5th ed. 1980).

⁴⁷ See *Schillner v. H. Vaughn Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943); *Cady v. Murphy*, 113 F.2d 988 (1st Cir. 1940), *cert. denied*, 311 U.S. 705 (1940).

⁴⁸ See, e.g., *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964). In *Lennerth*, an agent for the defendant corporation made the initial contact with the plaintiffs, explained all the details concerning the proposed venture and at that point stepped aside, theoretically excusing himself from the consummation of the sale and therefore avoiding § 12 liability. However, the court noted that the agent did everything but draw up and sign the contract, and since the plaintiff's injury was a direct and proximate result of the agent's actions, the agent was found to be a seller under § 12.

⁴⁹ See *Lennerth*, 234 F. Supp. at 59; *Filmways, Inc. v. Artistic Liquidating Corp.*, [1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,346 (S.D.N.Y. 1969); *MacClain v. Bules*, 275 F.2d 431 (8th Cir. 1960).

⁵⁰ See L. LOSS, *SECURITIES REGULATION* 1716 (1967), "plaintiff obviously would have the burden of proving . . . other persons had participated in an unlawful sale, a burden which would almost inevitably involve proof by the plaintiff of some sort of scienter on their part." *Id.*

emphasis on the importance of the interpretation of the term "seller." Although a complete discussion of judicial interpretation of the definition of "seller" could conceivably constitute an entire treatise, this article will attempt to provide a basic framework for an understanding of who is a "seller" for purposes of Section 12 liability.

As noted, a key to determining potential liability for attorneys serving as counsel to issuers is in the interpretation of the term "seller." Although there are still courts that cling to the notion that absolute privity is required between a buyer and a seller,⁵¹ the trend is toward more flexibility in determining who is a "seller."⁵²

In refusing to accept a more relaxed view as to who is a "seller" for purposes of Section 12 liability, the Third Circuit adopted the requirement of privity in *Collins v. Signetics Corp.*⁵³ In *Collins*, plaintiffs were purchasers of publicly offered stock who claimed that defendant corporation violated the disclosure provisions of Section 12.⁵⁴ Plaintiffs did not purchase stock from defendant corporation, but from two individuals who were members of the underwriting syndicate.⁵⁵ The court dismissed plaintiffs' claim and held that unless there was evidence that the issuer controlled⁵⁶ the seller-underwriters, the issuer lacked the requisite privity with the purchaser and therefore the plaintiffs' claim was dismissed.⁵⁷

⁵¹See *Turner v. First Wisconsin Mortgage Trust*, 454 F. Supp. 899, 912 (D. Wis. 1978). This court held that § 12(2) only created a cause of action against an immediate seller.

⁵²See Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How it Compares with Rule 10b-5*, 13 Hous. L. Rev. 231, 247-248 (1976). The author states that: "A clear trend in favor of extending the scope of the statute appears to be emerging. Originally, § 12(2) was given restrictive application, limited to the immediate seller or those in a 'controlling person' relationship, pursuant to § 15 of the Securities Act of 1933 with the seller. Those alleged merely to have 'aided and abetted' in the wrong, but not in privity with the seller, purchaser, or both, were held excluded from the coverage of § 12(2). However, there were some cases, even then, which recognized the possibility of § 12(2) being applied to persons directly involved with the seller in the commission of the wrongs alleged to give rise to liability, as well as brokers acting for the seller."

The main stumbling block appears to be that the only remedy available under § 12(2) is rescission, the theory being that it is only proper to provide such relief as against the one who received the consideration in the sale. On the other hand, in view of the liberal spirit intended for the statute, and as other decisions have expressly held that rescission is a proper remedy even under rule 10b-5 to apply against non-sellers, the scope of § 12(2) has been significantly expanded. Thus, recent cases have upheld rights of action under § 12(2) against lawyers, underwriters, accountants, and banks when they were shown to directly aided and abetted the wrong. (footnotes omitted).

⁵³605 F.2d 110 (3d Cir. 1979).

⁵⁴Plaintiffs purchased the stock for \$17 a share. Plaintiffs alleged that the parent company, Corning, failed to disclose the fact of its intention to entirely divest itself of its interest in Signetics. Plaintiffs further alleged that Signetics was aware of Corning's intentions and actively participated in the search for a buyer. Eighteen months after plaintiffs purchased the stock, Corning liquidated its interest in Signetics when Signetics merged into another corporation. As a result of the merger, Signetics shareholders were forced to surrender their stock for \$8 per share. *Id.* at 112-113.

⁵⁵Neither of the individuals from whom plaintiffs purchased the stock were named as defendants in the suit.

⁵⁶In discussing issuers control, the court was referring to § 15 of the 1933 Act which extends liability under §§ 11 and 12 beyond the immediate seller to a "controlling" individual.

⁵⁷*Collins*, 605 F.2d at 112-113. In justifying the decision, the court placed great emphasis on the exact statutory language of § 12, claiming that Congress intended that the section mean exactly what it says, that is, a purchaser may have a claim only against his immediate seller.

Although the Third Circuit still maintains a requirement of privity for a Section 12 claim, it is definitely in the minority.⁵⁸ In this trend toward a more expansive interpretation of a "seller," courts have generally applied four legal theories to justify the imposition of liability upon individuals other than the immediate seller of a security. First, the courts have attempted to measure the degree of participation of the seller's agent to determine if the agent's actions were a substantial part or proximate cause of the fraudulent sale.⁵⁹ Second, there is an imprecise test put forth by the Eighth Circuit which focuses upon the question of "whether the defendant was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings."⁶⁰ Third, liability is imposed if a defendant aided and abetted or conspired with the immediate seller to effectuate the fraudulent transaction.⁶¹ Finally, if an individual is a "controlling person" under Section 15 of the 1933 Act, that individual may also be held liable under Section 12 if they are involved in a fraudulent transaction.⁶² Although all four theories of liability are of great importance to attorneys, because the fourth test, the controlling person test, essentially has its basis in Section 15 of the 1933 Act, this article will only focus on the first three tests.

Degree of Participation

Although this appears to be a very nebulous concept, there are two standards that are generally applied in order to impose liability upon a defendant

⁵⁸See note 52 *supra*.

⁵⁹There are two approaches to finding liability under this theory. One, espoused by the 2nd Circuit requires that defendant actually participated in the transaction, and the other utilized by the 5th Circuit requires that a defendant's participation be a substantial factor in, or the proximate cause of the fraudulent transaction. Compare *Jackson v. Oppenheim*, 533 F.2d 826, 830 (2d Cir. 1976); *In re Ceaser's Palace Sec. Litig.*, 360 F. Supp. 366, 380 (S.D.N.Y. 1973) with *Croy v. Campbell*, 624 F.2d 709, 713-14 (5th Cir. 1980); *Pharo v. Smith*, 621 F.2d 656, 667 (5th Cir. 1980).

⁶⁰This theory appears to have been borrowed from a criminal law theory. For a good discussion of how courts extend § 12, which on its face only applies to immediate sellers, to apply to defendants who have aided and abetted an immediate sellers, to apply to defendants who have aided and abetted an immediate seller in a fraudulent transaction, see *Brick v. Dominion Mortgage & Realty Trust*, 442 F. Supp. 283, 306 (W.D.N.Y. 1977). In *Brick*, the court held that a party who was actively involved with or participated in a fraudulent sale, may be held liable under an aider and abettor or conspirator theory under § 12(2).

⁶¹*Wasson v. SEC*, 558 F.2d 879, 886 (8th Cir. 1977). Although in a latter case, the same court applied the "substantial factor test propounded by the Fifth Circuit, there was not a clear indication that the unique position test was being explicitly overruled. See *Stokes v. Lokken*, 664 F.2d 779, 785 (8th Cir. 1981). In fact, lower courts have continued to follow the test outlined by the Eighth Circuit in *Wasson* as controlling. See, e.g., *Lewis v. Shultz*, [1985-86 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,383 (E.D. Ark. 1985).

⁶²§ 15 of the 1933 Act extends liability under § 12 to persons who are controlling individuals. The section reads as follows:

"Every person who, by or through stock ownership, agency or otherwise, or who pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k [11] or 77l [12] of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to who such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77(o) (1975). This section of the 1933 Act specifically delineates when the privity requirement between a buyer and a seller may be statutorily circumvented.

who is not an immediate seller. The first, that of the Second Circuit, hinges upon whether or not the defendant actually participated in the transaction.⁶³ The second, outlined in detail by the Fifth Circuit, requires that the defendant's participation be a substantial factor in or the proximate cause of the fraudulent transaction.⁶⁴ Although the Fifth Circuit's test is generally believed to be more restrictive,⁶⁵ the Second Circuit has recently required that a defendant have active, meaningful or significant participation in the fraudulent transaction and essentially interpret the two tests as being the same.⁶⁶ Therefore, this article will primarily focus upon the degree of participation test as outlined by the Fifth Circuit.

The proximate cause requirement that is demanded by the Fifth Circuit test originated in *Lennerth v. Mendenhall*.⁶⁷ In *Lennerth*, an agent for the corporation issuing securities made the initial contact with the plaintiffs, and fully explained the specific details of the proposed transactions.⁶⁸ However, when the time ultimately arrived for the consummation of the transaction, the agent did not actually participate in the mechanics of the consummation.⁶⁹ A strict interpretation of Section 12(2) as utilized by the Third Circuit in *Collins*⁷⁰ would apparently excuse the defendant from liability. However, the *Lennerth* Court held that plaintiff's injury was a direct and proximate result of defendant agent's actions and therefore, agent could be found liable as a seller under Section 12(2).⁷¹

The first actual adoption of the proximate cause test in the Fifth Circuit was in the case of *Hill York Corp. v. American International Franchises, Inc.*⁷² The defendants in this case were controlling stockholders of American International Franchises (American), who had solicited local investors to incorporate state or regional franchise sales centers.⁷³ The individuals who were solicited by American, then sold stock to a third group of investors in the newly formed corporation.⁷⁴ The issue in the case was whether the original controlling stockholders in American were liable to the third group of investors even

⁶³See *supra* note 59.

⁶⁴*Id.*

⁶⁵See, e.g., *Wasson*, 558 F.2d at 879.

⁶⁶See *Katz v. David W. Katz & Co.*, [1984-1985 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,669 (S.D.N.Y. 1984).

⁶⁷234 F. Supp. 59 (N.D. Ohio 1964).

⁶⁸*Id.* at 64.

⁶⁹*Id.*

⁷⁰605 F.2d 110 (3d Cir. 1979).

⁷¹*Lennerth*, 234 F. Supp. at 65. The actual test for the determination of liability was phrased as follows: "But for the presence of the defendant . . . in the negotiations preceding the sale, could the sale have been consummated?" *Id.*

⁷²448 F.2d 680 (5th Cir. 1971).

⁷³*Id.* at 684.

⁷⁴*Id.*

though the original American stockholders had no contact with the third group of investors.⁷⁵ The court ultimately affirmed the trial court's decision in favor of the plaintiffs under Sections 12(1) and 12(2).⁷⁶

At first glance, it appears that the *Hill York* court may have taken two apparently inconsistent positions concerning the issue of who could be a "seller" under Section 12. On the one hand the court explicitly asserted that the law is well settled that a purchaser may only recover from his immediate seller.⁷⁷ This position would indicate that there could only be one proper defendant and that would be the actual person or entity who "directly" sold the security to a purchaser. However, in the very next sentence of the opinion, the court stated that it was presently unclear who could be a "seller" for purposes of the imposition of Section 12 liability.⁷⁸ The court did note that it is clear that the seller is not required to be the individual who actually passes title.⁷⁹ Although this was an apparent contradiction in positions, the court reconciled the dilemma by adopting the proximate cause analysis first set forth in *Lennerth*.⁸⁰

After the *Hill York* decision, subsequent Fifth Circuit decisions modified and ultimately refined the "proximate cause" test that the court used.⁸¹ In fact, the first Fifth Circuit case to address an analogous case restated the proximate cause test and refined it to require that the defendants actions were a "substantial factor" in the inducement of the fraudulent transaction.⁸² As a result of this refinement and modification, the test presently used by the Fifth Circuit is whether the defendant's participation is a "substantial factor" in, or the "proximate cause" of, the fraudulent transaction.⁸³ However, even the Fifth Circuit

⁷⁵*Id.* at 692. While previous cases may have held that this factor of no contact between the original American stockholders and the third group of investors would render the claim meritless, the court noted that this circuit had rejected the strict privity requirement on two prior occasions, citing *Strahan v. Pedroni*, 387 F.2d 730 (5th Cir. 1967); *Lynn v. Caraway*, 252 F. Supp. 858 (W.D. La. 1966), *aff'd per curiam*, 379 F.2d 943 (5th Cir. 1967), *cert. denied*, 393 U.S. 951 (1968).

⁷⁶*Hill York*, 448 F.2d at 685-86, 698.

⁷⁷*Id.* at 692.

⁷⁸*Id.*

⁷⁹*Id.*

⁸⁰*Id.* at 693 citing *Lennerth*. The court stated that in

"[A]pplying this test to the problem at hand, it is at once apparent that the defendants fall within its letter and spirit. The defendants were the motivating force behind this whole project. They sought out the original incorporators of Florida Franchise and then trained them to solicit additional capital for the corporation. They provided the sales brochures designed to secure this additional capital. They rendered advice on every aspect of the corporate formation and subsequent development. *In fact, the defendants did everything but effectuate the actual sale.* We can deduce with certainty that the plaintiffs would not have purchased this stock had the defendants not traveled to Florida carrying their bag of promotional ideas. 'The hunter who seduces the prey and leads it to the trap he has set is no less guilty than the hunter whose hand springs the snare.' Thus we find the defendants to be persons who sold or offered to sell within the meaning of Section 12(1) and, therefore, hold them liable under that section. (emphasis added)

(footnotes omitted.)

⁸¹*See, e.g.*, *Pharo v. Smith*, 621 F.2d 656 (5th Cir. 1980).

⁸²*Lewis v. Walston & Co.*, 487 F.2d 617, 622 (5th Cir. 1973).

⁸³*See Pharo*, 621 F.2d at 656.

has not been conclusively consistent in its determination of who is a "seller" under this test.

In *Croy v. Campbell*,⁸⁴ the Fifth Circuit held that a tax attorney, who advised his client about the tax ramifications of purchasing a limited partnership interest, did not provide plaintiff with sufficient grounds to establish that the attorney was a seller under Section 12(2).⁸⁵ In *Croy*, the defendant attorney arranged for plaintiffs to meet with the proposed real estate developer, and gave a good recommendation of the proposed investment as a tax shelter.⁸⁶ Although the defendant tax attorneys advice was an important consideration, the trial court held that since defendant made no representations concerning the investment other than to recommend the potential tax effects, nor did defendant try to actively induce plaintiffs to invest, that defendant was not a "seller" under Section 12(2).⁸⁷ In affirming the trial court's decision, the Fifth Circuit held that simply providing tax advice is not a "substantial factor" in causing the sale.⁸⁸ It does appear that *Croy* totally disregarded the relationship between the real estate developer and defendant attorney and the fact that the attorney arranged the initial contact between the plaintiffs and the real estate developer. Although it seems that *Croy* would exempt attorneys rendering routine advice, the court explicitly included a warning to attorneys when it stated that its holding "should not be interpreted to mean that a lawyer who participates in the transaction can never be the seller for purposes of section 12."⁸⁹

Soon after the *Croy* decision, the Fifth Circuit apparently relaxed the proximate cause test in *Junker v. Crory*.⁹⁰ In *Junker*, a defendant attorney was counsel to two companies involved in a merger and a controlling stockholder.⁹¹ As a proxy for the controlling stockholder, defendant-attorney proposed the idea of a merger, actually prepared the merger documents, made representations concerning the feasibility of liquidation, and actively persuaded shareholders to make stock purchases.⁹² Additionally, it was later alleged that many of defendant's representations were misleading and inaccurate.⁹³ In actuality,

⁸⁴624 F.2d 709 (5th Cir. 1980).

⁸⁵*Id.*

⁸⁶*Id.* at 711.

⁸⁷*Id.* at 712, 714.

⁸⁸*Id.* at 714. It provides interesting grounds for speculation to venture a guess as to whether or not defendants would have been liable if the court had simply applied the test first outlined in *Hill York*. Although there is no correct answer, one would suspect that the test may have been a little too stringent for the Fifth Circuit to maintain and follow.

⁸⁹*Id.*

⁹⁰650 F.2d 1349 (5th Cir. 1981).

⁹¹*Id.*

⁹²*Id.* at 1360. The court was very careful in distinguishing *Croy*. They noted that unlike the inactive part played by lawyer in *Croy*, the attorney in this case was not playing the role of a passive advisor, rather he "was an active negotiator in the transaction, acting as agent-in-fact as well as attorney-at-law, implementor not counsellor."

⁹³*Id.* at 1356. At the trial court, the judge found that Heisler, in representing both companies involved in a

the defendant attorney was nothing more than an agent for the seller, and he actively participated in the consummation of the transaction.⁹⁴ In affirming the trial court's holding, the Fifth Circuit held that defendant attorney was "an active negotiator in the transaction" and as such, by applying the proximate cause/substantial factor test, defendant attorney was a "seller" under Section 12.⁹⁵

As previously noted, it appears as if *Cory* and *Junker* may be potentially inconsistent. However, upon a closer comparison of the two cases, it seems as if the Fifth Circuit is suggesting that the imposition of liability under Section 12 can rest on the extent of the slight differences in the roles played by defendant-attorneys in the transactions. In *Croy*, the court apparently ignored the proximate cause aspect of the defendant's behavior. Additionally, the court overlooked the apparently cozy relationship defendant shared with the real estate developer. Instead, the court focused more on the nature of defendant's involvement rather than the proximate cause of plaintiff's injuries. In distinguishing *Croy*, the *Junker* court gave substantial attention to the differences between the passive advisor in *Croy* and the active negotiator in *Junker*.⁹⁶ However, assuming the court was correct in making such a distinction, we were given no indication of the point at which a defendant's actions become a substantial factor in the inducement of a transaction. Nevertheless, the Fifth Circuit's approach is much better than simply focusing on the requirement that a defendant participate in a transaction. At the very least, the Fifth Circuit has attempted to outline a framework which provides litigants an idea of how to evaluate potential claims. Unfortunately, the application of such a test does not preclude the imposition of liability upon an attorney who had no direct contact with a purchaser.

In *Excalibur Oil, Inc. v. Sullivan*,⁹⁷ defendant-attorney made oral misrepresentations to a purchaser of interests in oil and gas leases regarding the encumbrances on said leases.⁹⁸ Plaintiff brought suit against defendant-attorney claiming that they suffered damages as a direct result of defendant-

merger, was familiar with the financial conditions of both companies. Additionally, this court held that Heisler was intentional or reckless in failing to disclose the true value of the merging companies property.

⁹⁴*Id.* at 1360.

⁹⁵*Id.* It appears as if the court used a two-step process in determining defendant-attorneys liability. First, the court looked to defendant-attorneys amount of involvement in the transaction. After it was determined that defendant-attorney was indeed a seller for purposes of § 12(2), the court then reviewed defendant-attorneys statements that were made concerning the proposed transaction. It would be interesting to speculate on whether defendant attorney would have faced liability for his statements had he not been found to be a seller under § 12(2). Although it is quite possible plaintiffs could have been liable under another section of the 1933 Act, it is also possible that defendant-attorney may have been able to avoid the liability if the court had held his actions were not sufficient to implicate him as a "seller."

⁹⁶*Id.* For a better discussion of this point, review the comments and text accompanying *supra* note 92.

⁹⁷616 F.Supp. 458 (N.D. Ill. 1985).

⁹⁸*Id.* at 459-461.

attorneys alleged misrepresentations in connection with the sale of securities.⁹⁹ In defense of plaintiff's claim, defendant asserted that his preparation of title reports was merely participation in the events leading up to the transaction, and therefore, his participation would not provide a sufficient basis to impose seller liability under Section 12.¹⁰⁰ In rejecting defendant's contention, the court held that defendant's representations were certainly a "substantial factor in causing the transaction[s] to take place" and additionally that plaintiff's injuries were proximately caused by defendant's actions.¹⁰¹ Although defendant-attorney did ultimately have minor direct dealings with the plaintiff, the court did not provide an indication that this was an important fact.

While there appears to be no cut-and-dried answer as to who is a seller under the substantial factor/proximate cause test of the Fifth Circuit, one thing is certain, the imposition of liability is largely a factual question,¹⁰² and as such, attorneys should constantly be aware of the potential ramifications for rendering advice on a question involving securities in the Fifth Circuit.

Unique Position Test

The approach utilized by the Eighth Circuit focuses upon "whether the defendant was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings."¹⁰³ Although the Eighth Circuit utilized the Fifth Circuit's substantial factor/proximate cause test in a later case, the court provided us with no indication that they were abandoning the defendant's unique position test.¹⁰⁴ However, as evidence of the vitality of the unique position test we can find many cases that still apply the test.¹⁰⁵ Other courts, which place great emphasis on the defendant's involvement in the fraudulent transaction, (including the Second and Fifth Circuits), have essentially neglected to justify their decisions and rationale in terms of the legislative history of the 1933 Act that they are applying.¹⁰⁶ Although not necessarily

⁹⁹*Id.* at 459.

¹⁰⁰*Id.* at 465. Sullivan sought to rely on the holding in *Pharo*, 621 F.2d at 656.

¹⁰¹*Excalibur Oil*, 616 F.Supp. at 465. The court explicitly rejected defendant-attorneys' attempt to rely on the holding in *Pharo* and stated that "Sullivan [defendant-attorney] clearly falls within any of those formulations as much more than a 'mere participant'. His representations to title were certainly 'a substantial factor in causing the transaction[s] to take place.'" [Plaintiff's] injury 'flowed directly and proximately from the actions of Sullivan — in the classic tort-liability sense . . . [additionally] Sullivan was uniquely positioned to . . . acquire material information and disclose his findings' with regard to the crucial condition of title." (footnotes omitted)

¹⁰²*See Croy*, 624 F.2d at 714.

¹⁰³*Wasson v. SEC*, 558 F.2d 879 (8th Cir. 1977).

¹⁰⁴*See Stokes v. Lokken*, 644 F.2d 779, 785 (8th Cir. 1981).

¹⁰⁵*See, e.g., Excalibur Oil Inc. v. Sullivan*, 616 F.Supp. 458 (N.D. Ill. 1985).

¹⁰⁶*Wasson*, 558 F.2d at 886. The *Wasson* court expressly rejected the Fifth Circuit's test and stated that: "Our difficulty with the Fifth Circuit's proximate cause test is that it fails to elucidate or focus the trier of fact's attention on those policies which the Act was designed to implement and which, in our judgment, ought to be the basis for a sale or offer to sell determination."

reaching a different conclusion than the other tests, the Eighth Circuit in *Wasson v. Securities and Exchange Commission* attempted to focus its rationale on the policies of the Act as the court discerned them to be from the Act's legislative history.¹⁰⁷

The *Wasson* case arose when George Wasson, a broker, was suspended from practice for forty-five days by the SEC for selling unregistered securities.¹⁰⁸ Wasson was involved in the monitoring and subsequent sale of S&M Industries, Inc. common stock.¹⁰⁹ The title of the shares were actually held in the name of an officer of S&M Industries and the buyer of the stock was an automobile dealer who agreed to exchange title to seven vehicles for 30,000 shares of S&M Industries common stock.¹¹⁰ Wasson, as broker, handled all of the logistics of the transaction but failed to inform his superiors of the particular exchange in this transaction.¹¹¹ The stock was subsequently discovered to be unregistered and the SEC determined that Wasson's failure to fully investigate and disclose the nature of the transaction rendered him a "seller" of the securities under Section 5 of the 1933 Act.¹¹² Wasson subsequently appealed and the Eighth Circuit was then confronted with the issue of whether or not Wasson should be treated as a "seller."

In affirming the SEC's decision, the court indicated that the principal question to be answered was "whether [Wasson] was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings."¹¹³ The court determined that because Wasson's involvement was substantial and he had been aware of the slightly questionable circumstances of the "sale," that he was in a position to investigate the particulars of the transaction and then disclose his findings.¹¹⁴ Because the defendant's involve-

¹⁰⁷ *Id.* As a practical matter, irrespective of the rationale applied, given the facts of this case, it in all probability would have had the same outcome in either the Second, Fifth, or Eighth Circuits.

¹⁰⁸ *Id.* at 881-82. The SEC's decision was based on a determination that Wasson willfully violated §§ 5(a) and 5(c) of the 33 Act.

¹⁰⁹ *Id.* at 882.

¹¹⁰ *Id.* There were several facts that indicated this was a questionable transaction. Even more incriminating to Wasson was the fact that he had full knowledge of the potential improprieties. In detailing the facts known to Wasson and no one else, the Administrative Law Judge in the proceeding below stated:

"... but [what] Mr. Wasson did know, was that Davidson [the officer of S & M Industries] was not the owner of the shares, the Lincoln Automobiles were to be received by several persons other than Davidson, . . . and that the assignment of funds by Davidson to Prestige was in part designed to permit the delivery of the cars prior to the settlement date." *Id.*

¹¹¹ *Id.* It isn't apparent what effect this quashing of information by Wasson had on the outcome of the case. It is possible that Wasson could have pulled his employers into the litigation if he had made them aware of the transaction and they had not taken any affirmative action to stop the transaction.

¹¹² *Id.*

¹¹³ *Id.* at 886.

¹¹⁴ *Id.* at 887. The court was explicit in chastizing Wasson and stated:

In our judgment, Wasson's conduct fits squarely within the holdings of those cases and the meaning commonly given to the willful or reckless standard. He was aware of several facts suggesting the suspicious nature of the transaction. With reckless indifference to those facts, he proceeded to facilitate the sale, ignoring the obvious need for further inquiry and his duty to disclose all relevant information to his superiors. *Id.*

ment in the transaction was a major factor the court relied upon in imposing liability, it appears the Eighth Circuit's test is not quite as different as it would like to believe.¹¹⁵

Another case applying the unique position test was *Hagert v. Glickman, Lurie, Eiger & Co.*¹¹⁶ In *Hagert*, plaintiffs were purchasers of capital notes and warrants to purchase stock in Med General, Inc.¹¹⁷ Med General ultimately defaulted and the plaintiffs brought suit against Med General's board of directors, legal counsel, accountants and underwriters.¹¹⁸ In support of their claim, plaintiffs alleged that the prospectus and registration statement utilized in conjunction with the public offering of the notes, and the 1978 annual report of Med General contained materially false information and omissions of material fact.¹¹⁹ Plaintiffs named Med General's legal counsel as a defendant claiming that either or both an aiding and abetting or primary liability theory should be relied upon to impose liability upon the attorneys.¹²⁰ Although the court rejected the plaintiffs' aiding and abetting theory for the imposition of liability,¹²¹ it granted the plaintiffs leave to amend the primary liability allegation.¹²²

Unfortunately, *Hagert* did not consider the potential ramifications which would arise should the Eighth Circuit's test be applied to attorneys. The holding in *Hagert* seems to indicate that an attorney would be required to investigate his clients and subsequently disclose any material information revealed during those investigations. If this is actually what the Eighth Circuit requires, it appears that attorneys may be faced with the unattractive dilemma of deciding between the importance of attorneys' ethical obligations to their clients and the duties imposed on them by the federal securities laws as interpreted by the Eighth Circuit.

Another recent example of the potentially broad ramifications of the unique position test can be seen in the case of *Lewis v. Schultz*.¹²³ The litigation in *Lewis* resulted from an unsuccessful tax shelter venture.¹²⁴ Plaintiff purchas-

¹¹⁵See *supra* notes 106-107.

¹¹⁶520 F.Supp. 1028 (D. Minn. 1981).

¹¹⁷*Id.* at 1030-31.

¹¹⁸*Id.* Plaintiff attempted to assert that all defendants should face liability because they did not adequately describe the financial condition of the company.

¹¹⁹*Id.* at 1031.

¹²⁰*Id.*

¹²¹*Id.* at 1034. The court expressly rejected the aiding and abetting theory "notwithstanding the expansive view of privity generally taken with regard to [s 12]. . . [A]ccordingly, plaintiffs' claim of aiding and abetting . . . are dismissed with prejudice." (Footnotes omitted.)

¹²²*Id.* at 1035. The reason the court granted leave to amend was so plaintiffs could better apprise defendants of the conduct by which they allegedly violated the law. The court stated that:

"the defendants have a right to be informed whether they are being charged as principals or as control persons . . . To the extent that a particular defendant is being charged as a principal, he or it is entitled to be generally apprised of what kind of 'conduct' was engaged in that was an integral part of and a substantial factor in effectuating the sales." *Id.* at 1036.

¹²³[1985-1986 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,363 (E.D. Ark. September 23, 1985).

¹²⁴*Id.* The actual venture was a tax shelter that was formed for the purpose of acquiring and operating a fuel 17

ers in *Lewis* alleged that the partnership's attorney, accountants and engineers violated Section 12(2) of the 1933 Act in connection with the sale of the partnership interests in the unsuccessful tax shelter venture.¹²⁵ The plaintiff alleged that in connection with this unsuccessful venture that the defendant attorney:

- (1) prepared the offering memorandum;
- (2) prepared and filed the Certificate of Limited Partnership;
- (3) rendered a tax opinion;
- (4) rendered a legal opinion regarding the status of the partnership; and
- (5) represented the Partnership in connection with the purchase of certain property.¹²⁶

Because of this participation in the venture, plaintiffs asserted that the defendants were placed in the position of being under an affirmative duty of disclosure.¹²⁷ The court noted that it was quite possible that plaintiffs' allegations were indicia of nothing more than the rendering of routine services.¹²⁸ Unfortunately, the court relied on the *Wasson* test and held that it could be possible through further discovery, to ascertain whether or not defendant attorneys were "uniquely positioned to ask relevant questions, acquire material information or disclose [their] findings."¹²⁹ The court went further to hold that although *Wasson* was not an attorney, the principle of examination of all circumstances to determine a defendant's participation regarding his ability to acquire and subsequently disclose questionable circumstances should still be applied.¹³⁰

Obviously, the imposition of liability under the "unique position" test formulated by the Eighth Circuit circuit is essentially a factual one. Therefore, it would appear as if litigation involving attorneys alleged involvement in securities sales may be on the upswing. Acceptance of such a test would seemingly prevent courts from dismissing a case through means of a summary judgment or on the pleadings.

What should be of greater concern to attorneys, is the potential imposition of liability for the rendition of routine services. Because the "unique position" test is imprecise and vague at best, it presents the possibility that professionals rendering routine services could face liability. Additionally, we are not told what the duties of care will be. For example, are attorneys to be held to a higher standard than accountants? Unfortunately, the Eighth Circuit has not

grade ethanol plant in Louisiana. The venture was set up as a limited partnership and the plaintiffs were subscribers to the partnership.

¹²⁵ *Id.* at ¶ 92,319.

¹²⁶ *Id.*

¹²⁷ *Id.* It is apparent that the plaintiffs were directly relying on *Wasson* as precedent.

¹²⁸ *Id.* Although the court recognized the contributions of *Croy*, the holding indicated that the reasoning put forth by the Eighth Circuit was more persuasive.

¹²⁹ *Id.*

answered these questions. However, if the trend is an accurate tool for prognostication, attorneys should remain attuned to the potential liability they may face for merely rendering routine advice to a corporate client issuing securities.

Aiders and Abettors under Section 12

Although this theory of imposing liability has not resulted in the amount of litigation that the "seller" definition or the "unique position" test, it is still worth noting as a potential hazard to attorneys. Originally Section 12(2) was given a restrictive application. The imposition of liability under Section 12 was confined to the immediate seller or those who were in a controlling person relationship with the seller.¹³¹ Individuals who allegedly "aided and abetted" the fraudulent transaction, but who were not in privity with either the buyer or seller were excluded from the coverage of Section 12(2) liability.¹³² However, such is no longer the case today. Alleged aiders and abettors under Section 12(2) in *In re Caesars Palace Securities Litigation* were ultimately found liable to the plaintiffs under Section 12.¹³³ The alleged aiders and abettors in *Caesars Palace* were certain stockholders, employees, officers and partners of the corporation and partnership that sold Caesars Palace Hotel and Casino to the principal defendants and the immediate seller, Caesars World.¹³⁴ In attempting to avoid liability, the defendants tried to rely on *Barlas* and other decisions which strictly interpreted Section 12.¹³⁵ In rejecting the defendant's arguments, the court held that individuals who are aware of or who participate in the securities law violation and who provide assistance to the principle wrongdoers should also be held liable under Section 12.¹³⁶

¹³¹See note 52 *supra*.

¹³²*Barlas v. Bear, Stearns & Co.*, [1966 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 91,674 (N.D. Ill. 1966). In holding that a theory of aiding and abetting was not a sufficient cause of action, the court stated: "The only allegation made by plaintiff . . . [is] that all defendants 'aided and abetted' Karl Hope and Bear, Stearns & Co. Such an allegation is not sufficient, inasmuch as plaintiff has failed to invoke the 'control' provisions of Section 77(o), [15] and the Securities Act makes no provision for liability of parties on conspiracy grounds . . . we must therefore rely on the clear language of the Statute . . . and the prevailing case law which holds that, in the absence of 'control' allegation, a defendant shall only be liable 'to the person purchasing such security from him.'" *Id.* at ¶ 95,478.

¹³³360 F.Supp. 366 (S.D.N.Y. 1973).

¹³⁴*Id.* at 375. Although this case does not involve the imposition of liability upon an attorney, the reasoning that the court used in holding defendants liable could be readily implemented by a court seeking to impose liability upon an attorney.

¹³⁵*Id.* at 382. Other cases that defendant attempted to rely upon include: *Dorfman v. First Boston Corp.*, 336 F.Supp. 1089 (E.D. Pa. 1972); *Lynn v. Caraway*, 252 F.Supp. 858 (W.D. La. 1966), *aff'd*, 379 F.2d 943 (5th Cir. 1967), *cert. denied*, 393 U.S. 951 (1968); *First Trust & Savings Bank of Zanesville, Ohio v. Fidelity-Philadelphia Trust Co.*, 112 F.Supp. 761 (E.D. Pa. 1953), *aff'd*, 214 F.2d 320 (3d Cir. 1954), *cert. denied*, 348 U.S. 856 (1954).

¹³⁶*In re Caesar's Palace*, 360 F.Supp. at 382-83. The court was extremely explicit in rejecting defendants arguments and stated: "The fundamental purpose of the Federal securities laws, . . . is to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." To this end, the courts have continually recognized the broad, remedial nature of the 1933 Act and the need to adopt a liberal interpretation of the statute in order to best effectuate the congressional purpose . . . Our interpretation of § 12(2) is, we believe, wholly consistent with these ends." (citations omitted).

Although there are apparently as of yet no cases that have applied the aider and abettor theory of liability under Section 12 to defendant-attorneys, caution should nevertheless be maintained due to the potential for expansion of this theory of liability.

POTENTIAL CLAIMS UNDER THE SECURITIES AND EXCHANGE ACT OF 1934

Section 10(b) Claims

This is the area of the federal securities laws which present the greatest area of concern for attorneys. It is generally accepted that there are two theories under which Section 10(b) liability may be imposed upon an attorney. The first, primary liability, stems from the misconduct of the attorney. The second, secondary liability, stems from the fact that an attorney aided and abetted a wrongdoer.

At one time, the threshold issue for determining potential violations of Section 10(b) was whether or not negligent behavior would suffice to sustain a cause of action. Early case law seemed to suggest the possibility that an attorney who negligently investigated the representations made to him in a client's prospectus information, may face liability under Section 10(b) and Rule 10b-5 promulgated thereunder of the 1934 Act.¹³⁷ However, the Supreme Court has more recently interpreted Section 10(b) to prohibit fraud in connection with the sale of a security.¹³⁸ This requirement of fraud quite obviously requires that the attorney be guilty of something greater than mere negligence.

Section 10(b) of the 1934 Act essentially allows claims to be imposed on any individuals who make representations with respect to or in connection with the sale of securities.¹³⁹ Unlike Section 12 of the 1933 Act, a defendant is not required to be a seller, or even a promoter to be exposed to potential liability under Section 10(b) of the 1934 Act. It is for this reason that attorneys performing even routine services face the greatest risk of liability under this section.

Direct Liability

The theory that an attorney can be held liable under Section 10(b) of the

¹³⁷SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

¹³⁸Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

¹³⁹The primary area of this inquiry will focus on violations of Rule 10b-5 promulgated under § 10(b) of the 1934 Act. This rule states that: "It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

1934 Act for direct participation in a securities transaction can be traced to the frequently cited case of *SEC v. Frank*.¹⁴⁰ In *Frank*, defendant-attorney prepared the offering prospectus for a New York intrastate securities offering of the Nylo-Thane Plastics Corporation.¹⁴¹ The initial offering of the stock consisted of 100,000 shares of common stock at \$3.00 per share, however immediately following the completion of the public offering, the stock traded as high as \$17.50 per share.¹⁴² The Securities and Exchange Commission subsequently discovered what it considered to be serious misrepresentations in the offering circular.¹⁴³ As a result of this, on April 27, 1967, the SEC suspended trading in the stock.¹⁴⁴ Subsequently, Nylo-Thane retained new counsel to help clear up the discrepancies and misrepresentations in the offering circular.¹⁴⁵ Thereafter, the SEC instituted an action against all parties involved in the offering to enjoin any further misrepresentations.¹⁴⁶ All defendants, excluding Frank, agreed to the entry of a permanent injunction.¹⁴⁷ Because Frank refused to consent to the injunction, the SEC sought and was ultimately granted an injunction enjoining Frank *pendente lite* from drafting any untrue statements concerning the principal product of a corporation.¹⁴⁸ It is from that ruling that Frank appealed.

Frank asserted that in granting an injunction, the court was placing liability on a scrivener whose sole function was to help the officers of Nylo-Thane prepare their offering circular in proper form and that he did not substantively participate.¹⁴⁹ In rejecting Frank's assertions, the court stated that "[I]n our complex society the . . . lawyer's opinion can be [an] instrument for inflicting pecuniary loss more potent than the chisel or the crowbar."¹⁵⁰ However, the court also provided an indication that it would be unreasonable to impose liability upon an attorney who merely put a client's description of a highly technical chemical process into understandable English.¹⁵¹ Nevertheless,

¹⁴⁰388 F.2d 486 (2d Cir. 1968).

¹⁴¹*Id.* at 487.

¹⁴²*Id.* at 487-88.

¹⁴³*Id.* at 488.

¹⁴⁴*Id.*

¹⁴⁵*Id.*

¹⁴⁶*Id.* The SEC action was instituted against Nylo-Thane, three officers or stockholders of Nylo-Thane, a financial consultant to the corporation, and attorney Frank.

¹⁴⁷*Id.* As a practical matter this is a big time saver. Although defendants consent to an injunction, they neither admit nor deny the allegations in the complaint. This willingness to consent to a permanent injunction keeps the parties involved relatively happy while avoiding the time and expense involved in potentially protracted litigation.

¹⁴⁸*Id.* at 487.

¹⁴⁹*Id.* at 488.

¹⁵⁰*Id.* at 488-89, citing *U.S. v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964), cert. denied, 377 U.S. 953 (1964). The court went even further to inform us that a lawyer has no privilege to assist in the circulation of an offering circular which he knows to contain false statements simply because his client provided him with the information.

¹⁵¹*Frank*, 388 F.2d at 489. It would be unreasonable to find fraud because the attorney lacked the technical ability to fully understand slight discrepancies between the technical data and his translations.

in *Frank*, the court did impose liability because the defendant was supplied with information that even a non-expert would recognize as containing false statements.¹⁵² The court went on to hold that "a lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand."¹⁵³

A more recent imposition of liability under Section 10(b) upon an attorney can be seen in *Felts v. National Account Systems Association, Inc.*¹⁵⁴ In *Felts*, plaintiffs were purchasers of twelve-month promissory notes issued, offered, sold and delivered by National Account Systems Association (NASA).¹⁵⁵ NASA offered these unregistered securities through means of oral and written representations via brochures, offering circulars, packets and letters.¹⁵⁶ NASA was represented to be a factoring company who supposedly factored the accounts receivable of established manufacturing and retail firms.¹⁵⁷ At the incorporation of NASA, the president and counsel for the firm was an attorney named Peters.¹⁵⁸ However, defendant Peters was aware from the start that his presidency was merely titular and his authority, at least as president, was in actuality exercised by someone else.¹⁵⁹ NASA subsequently began selling the promissory notes through the methods previously noted.¹⁶⁰ These sales were effectuated through the utilization of false and misleading materials.¹⁶¹ Although all of the defendants in the trial were held to be jointly and severally liable,¹⁶² this discussion will focus on the liability imposed upon the attorney.

In reaffirming the *Frank* decision, the court held that an attorney has no privilege to assist in the circulation of false offering materials simply because they were supplied to him by his client.¹⁶³ However, the court was more adamant in its position and stated that "the lawyer for the issuer plays a unique and pivotal role in the effective implementation of the securities laws," because of this, special duties are to be imposed on the lawyer.¹⁶⁴ These duties include

¹⁵² *Id.*
¹⁵³ *Id.*¹⁵⁴ 469 F.Supp. 54 (N.D. Miss. 1978).¹⁵⁵ *Id.* at 58. What actually prompted the suit was that defendant was in default on interest payments to the noteholders.¹⁵⁶ *Id.* at 59.¹⁵⁷ *Id.* A firm involved in factoring essentially serves as a provider of cash flow for firms that are in need of a faster cash flow. Factoring involves the purchase of a firm's accounts receivable. These purchased accounts are bought at a discount and subsequently collected at face value. Therefore, the spread between the discount and the face value would be a factoring company's profits.¹⁵⁸ *Id.* at 60.¹⁵⁹ *Id.*¹⁶⁰ *Id.*¹⁶¹ *Id.* at 60-62.¹⁶² *Id.* at 70. This excludes of course those individual defendants with whom settlement was reached during the trial.¹⁶³ *Id.* at 67.¹⁶⁴ *Id.* The court was explicitly in its demands of attorneys in the field of securities law and stated:

"The securities laws provide a myriad of safeguards designed to protect the interests of the investing

the obligation to exercise due diligence, including reasonable inquiry with respect to responsibilities he has voluntarily undertaken.¹⁶⁵ Furthermore, he has an affirmative duty to make a "reasonable" and "independent" investigation to determine and correct false or misleading statements.¹⁶⁶ Additionally, if an attorney has a relationship with the purchaser, the attorney will face an even stricter standard of investigation and disclosure.¹⁶⁷ In reviewing the standards of care the court had accepted as applicable, the court ultimately held that without the affirmative assistance of Peters, the sales would not have been consummated.¹⁶⁸ Although Peters was also the "President" of NASA, apparently the lack of this factor would not have prevented the court from imposing liability upon Peters. Although this discussion of case law for imposing liability under Section 10(b) for direct participation by an attorney is far from exhaustive, it indicates that an attorney who simply drafts a misleading prospectus or offering circular may be held liable under Section 10(b), even if that was the total extent of his involvement. In fact, a recent Supreme Court decision specifically allowed for the possibility of holding an attorney liable under Section 10(b) for rendering professional services. In *Herman and MacLean v. Huddleston*,¹⁶⁹ the court determined that Section 10(b) should be given a broad reading and its application should not be narrowed by existence of an express remedy under Section 11 of the 1933 Act. The court stated that certain individuals, who assisted in the preparation of registration statements, including lawyers not acting as experts, cannot be reached under Section 11 of the 1933 Act, and if we did not apply Section 10(b) of the 1934 Act, such individuals would be immune from liability.¹⁷⁰ Such an application of the federal securities laws would be wholly inconsistent with their remedial purposes.¹⁷¹

A recent decision firmly entrenched the theory that an attorney could face Section 10(b) liability for merely rendering routine services. In *Reingold v. Deloitte Haskins & Sells*, one of the defendants was an attorney retained by a foreign corporation for the purpose of insuring that the corporation complied with federal securities laws.¹⁷² When plaintiffs subsequently filed suit for violations of Section 10(b), the defendant-attorney asserted that he was merely rendering professional services and acting in an advisory capacity and therefore, he should not be subject to liability under Rule 10b-5.¹⁷³ The court

public. Effective implementation of those safeguards, however, depends in large measure on the members of the bar who serve in an advisory capacity to those engaged in securities transactions."

Id. citing, SEC v. Spectrum, Ltd., 489 F.2d 535, 536 (2d Cir. 1973).

¹⁶⁵ *Id.*

¹⁶⁶ *Id. citing*, Escott v. Barchris Constr. Corp., 283 F.Supp. 643 (S.D.N.Y. 1968).

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 68.

¹⁶⁹ 459 U.S. 375, 386 (1983).

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 386-87.

¹⁷² 599 F.Supp. 1241, 1267-68 (S.D.N.Y. 1984).

refused to accept the defendant's argument and held that if the plaintiff's complaint "only" alleged claims against the defendant-attorney for filing the registration statements, such a cause of action would still be sufficient.¹⁷⁴

Obviously, if an attorney who renders routine professional services may face Section 10(b) liability, then an attorney whose participation involves more than the mere rendering of professional services will most definitely face the threat of Section 10(b) liability. Such additional involvement is exactly what placed liability upon defendant attorneys in the case of *Freschi v. Grand Coal Venture*.¹⁷⁵ In *Freschi*, not only did the defendant-attorneys materially misrepresent the facts involving the tax shelter program of Grand Coal Ventures, the defendants actually participated in the marketing and organization of such venture.¹⁷⁶ Additionally, the law firm where defendant-attorneys were partners was also involved in the Grand Coal Ventures.¹⁷⁷ For these reasons, the court held that defendant attorneys, as well their law firm, should face liability under Section 10(b) of the 1934 Act.¹⁷⁸

Although it is obvious that an attorney may face liability for merely rendering professional services, they are not without a defense. To avoid liability an attorney may claim that he lacked the requisite scienter or he was technically inadequate to appreciate the falsities.¹⁷⁹ However, both of these defenses are difficult to successfully assert and should be viewed as possible defenses and not definitive ways to avoid liability.

Aiders and Abettors under Section 10(b)

Of greater concern to attorneys is the potential for being held liable for assisting someone in the commission of a violation of the federal securities laws. Although neither the federal securities laws or Rule 10b-5¹⁸⁰ specifically delineate a cause of action for aiding and abetting liability, the courts have apparently judicially promulgated such liability.¹⁸¹ The reason this imposition of aiding and abetting liability for attorneys is so important is that, in most cases, the attorney is not the principal wrongdoer. Additionally, as a practical matter, the plaintiff will attempt to draw as many defendants into a cause of action as

¹⁷⁴*Id.*

¹⁷⁵767 F.2d 1041 (2d Cir. 1985).

¹⁷⁶*Id.* at 1048-49.

¹⁷⁷*Id.* at 1049. The law firm where defendant-attorneys were partners in actuality had extensive involvement with the name defendant. Three of the principals of the Grand Coal Venture were partners in the law firm. The law firm's physical facilities were utilized to market the fraudulent Grand Coal Venture scheme. Finally, the finances of both groups were deeply intertwined.

¹⁷⁸*Id.*

¹⁷⁹*See Frank*, 388 F.2d at 486.

¹⁸⁰For the text of this Rule, see *supra* note 139.

¹⁸¹*See, e.g., SEC v. Seaboard Corp.*, 677 F.2d 1301, 1312 (9th Cir. 1982); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 119-20 (2d Cir. 1982); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

possible in an effort to find the deepest pocket.¹⁸²

Although the actual test for aiding and abetting varies slightly among the circuits, the courts have generally delineated three elements that are required to successfully establish aiding and abetting liability under Rule 10b-5. These elements are:

- (1) some individual (primary violator) has committed a violation of Rule 10b-5;
- (2) that the defendant had knowledge of or recklessly disregarded the violation; and
- (3) that the defendant substantially assisted in or substantially participated in the fraud.¹⁸³

For the first requirement to be met, the plaintiff must show that some other person has actually committed a securities law violation.¹⁸⁴ All that plaintiff need show is that the primary violator's actions would be sufficient to meet the requirements of an ordinary civil claim under Rule 10b-5.¹⁸⁵ Although there is usually little difficulty in establishing who is the primary violator, this must still be given adequate attention by the plaintiff so that the court can determine the collateral parties who should be subjected to potential aiding and abetting liability.¹⁸⁶ Although a primary violator is generally given little attention, without the establishment of one, a defendant cannot be held liable as an aider and abettor.¹⁸⁷ However, even though this is a key element, the majority of attention has consistently focused on the knowledge or assistance elements.¹⁸⁸

In order for the second requirement to be met, a plaintiff must show that the defendant attorney had a general awareness that his role was part of an overall activity that was improper.¹⁸⁹ However, some courts have even gone so

¹⁸²For a good discussion of the theories of secondary liability under the federal securities laws, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

¹⁸³See, e.g., SEC v. Seaboard Corp., 677 F.2d 1301, 1311 (9th Cir. 1982); Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981); Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir. 1980), cert. denied, 449 U.S. 919 (1980); IIT v. Cornfield, 619 F.2d 909 (2d Cir. 1980); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799 (3rd Cir. 1978), cert. denied, 439 U.S. 930 (1978); Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975).

¹⁸⁴SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975).

¹⁸⁵For a good discussion of the elements for a private cause of action under Rule 10b-5, see Comment, *Rule 10b-5 Liability After Hochfelder: Abandoning the Concept of Aiding and Abetting*, 45 U. CHI. L. REV. 218, 219 n. 7 (1977).

¹⁸⁶Ruder, *supra* note 182, at 628-30.

¹⁸⁷See *Morgan v. Prudential Funds, Inc.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,345 at 93,172 (S.D.N.Y. 1978); Ruder, *supra* note 182 at 630. In *Morgan*, the court dismissed plaintiff's claim for failing to properly allege a primary violation of rule 10b-5.

¹⁸⁸Ruder *supra* note 182, at 630. Ruder refers to the primary violation requirement as the "unarticulated premise."

¹⁸⁹Coffey, 493 F.2d at 1316.

far as to expand this element and require that defendant merely know of the primary violation.¹⁹⁰ Although this expansive position is sometimes recognized, it is generally viewed as too expansive and that the proper standard to be utilized in determining whether or not there was knowledge is whether or not defendant-attorney's knowledge can be shown by circumstantial evidence, or reckless conduct.¹⁹¹ However, the proof must demonstrate the actual awareness of the attorney's role in the fraudulent transaction.¹⁹² In discussing the factors in determining whether or not the knowledge requirement has been met, the Fifth Circuit indicated that the nature of the transaction, the particular type of security involved, and any duties that the law has imposed on defendant are all critical factors and must be reviewed in determining whether the knowledge element is met.¹⁹³

The third element, substantial assistance, seemingly presents a major hurdle for a plaintiff to overcome. However, courts have frequently determined that activities generally viewed as the rendition of routine services could constitute substantial assistance.¹⁹⁴ Additionally, courts have held that if a defendant has an affirmative independent duty to disclose a wrongdoing, that this conduct may fulfill the substantial assistance element.¹⁹⁵ Even without the proof of fraud, an attorney who drafted a prospectus or filed registration statements with the SEC could be found to have substantially assisted a wrongdoer.¹⁹⁶

Although the application of substantial assistance has at times been troublesome for courts,¹⁹⁷ they have generally reviewed the facts of each case and rather than formulating a precise definition, have placed greater emphasis on the totality of the circumstances rather than the precision of a definition.¹⁹⁸

As one can see, it seems relatively easy to impose liability on an attorney for aiding and abetting a violator of Rule 10b-5 and Section 10(b) of the 1934

¹⁹⁰See *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

¹⁹¹See *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975).

¹⁹²*Id.* at 96.

¹⁹³*Id.* at 95-97.

¹⁹⁴See *Fletcher v. Kletz*, 266 F.Supp. 180 (S.D.N.Y. 1967). In *Fletcher*, the court found substantial assistance where an accounting firm prepared a financial report. The court denied the accounting firms motion to dismiss because they failed to make a timely disclosure of misleading figures in the certified financial statements.

¹⁹⁵See, e.g., *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 106 S.Ct. 798 (1986); *Woodward*, 522 F.2d at 84; *Dirks v. SEC*, 681 F.2d 824, 844-46 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983). In *Dirks*, the court held that the defendant violated rule 10b-5 as an aider and abettor because he failed to disclose the existence of a fraud when he had "a duty to the public and to the SEC not to foster the sale of fraudulent or worthless securities."

¹⁹⁶*Felts*, 469 F. Supp. at 54. For a discussion of the facts in *Felts*, see notes 153-167 and accompanying text, *supra*.

¹⁹⁷For a good discussion on the historical difference of opinions in the various circuits in attempting to define substantial assistance, see, Note, *Rule 10b-5: Liability for Aiding and Abetting After Ernst & Ernst v. Hochfelder*, 28 U. FLA. L. REV. 999, 1010-14 (1976).

¹⁹⁸See A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 8.5 (531), at 208.20-21 (1983). <http://change.uakron.edu/akronlawreview/vol20/iss3/8>

Act. In attempting to defeat such a claim, an attorney could possibly claim that he had made reasonable efforts to ascertain the veracity of the data given to him by the client.¹⁹⁹ However, to do so would tend to infringe on a client's potent defense of reasonable reliance upon counsel.²⁰⁰ Although reliance upon counsel will not allow a client to totally avoid liability,²⁰¹ a client may seek to rebut a claim of fraud by showing he had acted in reliance on a reputable, well chosen law firm and that he fully disclosed all material information. This is where the potential conflict arises for attorneys. On the one hand, they are anxious to avoid the imposition of liability upon themselves. However, if they intend to maintain an on-going relationship with the client charged with the primary violation, they may not want to discredit a potentially effective defense for their client. As you can see, an attorney caught in such a dilemma may be forced to "foot the bill" to maintain an ongoing business relationship with a lucrative client. Therefore, it is of the utmost importance that attorneys expend all practical effort in ascertaining the legality or veracity of a transaction on behalf of their client, prior to its commencement.

CONCLUSION

Although there are other situations where an attorney, providing service to a corporate client issuing securities, may be potentially liable for securities law violations,²⁰² the objective of this article was not to provide an exhaustive compilation of potential liabilities. Instead, the focus was to illustrate the trend and potential for liability being imposed upon members of the securities bar in situations that were most likely to occur in practice. As one can see, the isolated Sections of the federal laws that were addressed in this article revealed voluminous amounts of litigation.

As an overview, there are several observations that should be of major significance to members of the securities bar. First, there is definitely a trend toward the imposition of liability upon attorneys in cases involving securities law violations. Second, as plaintiffs become more aware of this potential liability, more attorneys will be named as defendants in litigation involving securities law violations. Third, it will be extremely difficult to dispose of a claim prior to trial with techniques such as a summary judgment or a motion to dismiss. Because of this, one should expect the threat of litigation to become a more

¹⁹⁹In utilizing this defense, an attorney could also attempt to avoid liability under § 12 of the 1933 Act and § 14 of the 1934 Act.

²⁰⁰For a good discussion of the usage and elements of the defense of reliance upon counsel, see Hawes and Sharrad, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 Va. L. Rev. 1, 19-40 (1976). For a defendant to claim this defense he must show that in good faith and with due care he: (1) selected counsel he believed to be competent; (2) disclosed to counsel all facts which he believed to be relevant; and (4) acted in accordance with such advice after it had been rendered. (footnotes omitted)

²⁰¹SEC v. Savoy Industries Inc., 665 F.2d 1310 n. 28 (D.C. Cir. 1981).

²⁰²Other areas of liability that may impose liability upon attorneys for rendering advice to corporate clients issuing securities include "control person" liability under § 15 of the 1933 Act and § 20 of the 1934 Act. Another potentially dangerous area could be the expansive application of state and federal Rico statutes.

powerful tool against potential attorney-defendants in securities law cases. Finally, because of all of these negative factors resulting from this expansion of liability under the federal securities laws, the people who will suffer the most are the individuals or corporations seeking the services of a securities attorney. Although there are obviously instances where an attorney has violated the federal securities laws, it appears as if the courts are attempting to judicially broaden the statutory scheme of liability imposed upon attorneys. While it is important that investors are afforded protections under the securities laws, it does burden the people in need of a securities attorney's services. This expansion of liability will ultimately force attorneys to become extremely cautious. Additionally, it is quite possible that the already expensive fee schedule for securities advice will undergo a boost to compensate the attorneys for the added threat of liability.

Although it is apparent that investors should be afforded some degree of protection, it is not apparent that they should be able to impose wholesale liability upon everyone involved in securities transactions. Granted, those attorneys who have willfully violated the federal securities laws should face liability, it seems unfortunate that attorneys merely rendering routine advice to corporate clients issuing securities may now also face liability.

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